AN INQUIRY INTO THE NATURE AND ACCOUNTING OF CORPORATE CONTINGENCIES

A THESIS

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Carolyn M. Brown

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CHAPTER ONE

INTRODUCTION

Purpose of the study.--This thesis is designed to analyze that section of the balance sheet termed "contingencies" and/or "reserve for contingencies". This item of the balance sheet, regardless of its "remoteness", has a purpose.

It is hoped that this thesis will generate enough information about contingencies to act as a reference material for anyone curious about the item and especially for the first-year accounting student who is oftentimes puzzled as to the nature, accounting, and significance of contingencies. This is not unusual. Even some certified public accountants will not hesitate to admit to an inquirer that this item often baffle them. Of course, the nature of a company's operations and the accounting techniques it utilizes play a significant part in determining whether a company will need to designate certain items as contingent or not.

Determination of the items to be included in the contingency account(s) is in most instances left to the discretion of the accountant.

It should be remembered that not all items of the balance sheet classified as contingencies are "legal" contingencies. (They do not possess all of the characteristics of contingencies as stated by the American Institute of Certified Public Accountants.) Some of these items are: reserves for depreciation and obsolescence, allowance for bad debts, and reserve for investment losses.

Although the term "reserve" may be found in any of the three main sections of the balance sheet, recommendations have been made for restricting the use of the term reserve to the retained earnings section to avoid any confusion which may result from its use in titles of accounts of differing nature. "In Accounting Research Bulletin No. 34 (1948), it was recommended that account titles containing the term reserve be restricted to use with accounts reflecting segregations or appropriations of retained earnings."[1] As a result of this recommendation, we may conclude that the reserve for contingencies account is to be found in the retained earnings section of the balance sheet. However, several companies still place the account between the liability and retained earnings sections. When the latter approach is used, the amount thereof is not included in the computation of any of the totals.

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[1]AICPA, "Accounting Research Bulletin No. 50," Accounting Research and Terminology Bulletins (Final ed.; New York: AICPA, 1961), p. 37.

Scope and limitations.--Although many of the items discussed may relate to other types of industries, this paper is concerned specifically with manufacturing industries.

Less emphasis is placed on asset contingencies than on liability contingencies because there are fewer situations in which asset contingencies may be encountered.

The contingencies discussed therein relate to:

(1) those not sufficiently predictable to permit recording in the accounts, but in which there is a reasonable possibility of an outcome which might materially affect financial position or results of operations . . . and

(2) those where the outcome is reasonably foreseeable, such as probable tax assessments which will not be contested, or anticipated losses from uncollectible receivables.[1]

General risk contingencies such as war, strike, or business recessions are not discussed because they are of a general nature and are not limited specifically to the manufacturing industries.

Some of the items which may be classified as contingent assets are:

(1) claims against others for patent infringement,

(2) claims for reimbursement under condemnation proceedings,

(3) price redeterminations upward.[2]

Some of the items which may be classified as contingent liabilities are:

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[1] *Ibid.*

[2] *Ibid.*

(1) liability for additional taxes,

(2) notes receivable discounted with recourse,

(3) accounts receivable assigned with recourse,

(4) accommodation endorsements of commercial paper,

(5) guaranties of the obligations or liabilities of others,

(6) commitments to purchase or to sell,

(7) construction commitments,

(8) guaranties of quality or performance of goods sold,

(9) salary or bonus contracts with officers or employees,

(10) pending litigations,

(11) probable liability under agreements,

(12) possible liability for violation of business regulatory laws.[1]

Generally the reserve account, which is usually located between the liability and capital sections or in the capital section, is found to be somewhat limited because of its kinship to the liability contingencies.

Definitions of terms.--Contingencies are those "existing conditions, situations or sets of circimstances, involving a considerable degree of uncertainty, which may, through a related future event, result in the acquisition or loss of an asset, or the incurrence or avoidance of a liability, usually with the concurrence of a gain

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[1]Ralph Kennedy and Stewart McMullen, Financial Statements (New York: Richard D. Irwin, Inc., 1962), p. 559.

or loss."[1]

"A contingent asset is one the existence, value, or ownership of which depends upon the occurrence or non-occurrence of a specific event or upon the performance or nonperformance of a specified act."[2]

"A contingent liability exists when there is no present debt but when the conditions are such that a liability may develop, usually as the result of an action or default by an outsider."[3]

Liability contingencies may be characterized by two vital conditions:

(a) the occurrence of an event which would create a liability is possible or may be anticipated with a reasonable certainty, or

(b) past events have created a liability the amount of which is not determinable with a reasonable degree of accuracy.[4]

Contingent liabilities are held by many to be synonymous with contingent losses. This is not so; there exists a distinct difference between the two.

> A loss may be sustained without creating a liability, as when a business loses property by fire or other casualty. Despite this distinction, contingent liabilities are sometimes confused with contingent losses. Book entry of the probable loss is made with an offset to a so-called 'liability reserve'".[5]

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[1]AICPA, *op. cit.*

[2]Kennedy and McMullen, *op. cit.*

[3]*Ibid.*

[4]Herbert E. Miller, *C. P. A. Review Manual* (New Jersey: Prentice-Hall, Inc., 1965), p. 95.

[5]Morton Backer, *Handbook of Modern Accounting Theory* (New Jersey: Prentice-Hall, Inc., 1955), p. 181.

And to make the matter more complex, several authorities associate contingent losses with general contingency reserves.

Contingency reserves, which are established in the majority of cases only in conjunction with liability contingencies, are those "segregated earmarkings of earned surplus evidenced by the creation of a subordinate account; appropriated surplus: a true reserve. The earmarking may be temporary or permanent . . . "[1]

In relation to the latter definition it may be said that reserve for contingencies is a "bookkeeping entry set up out of the owners' accounts to create a buffer against some event which management is afraid may happen but which they hope will not happen."[2]

Arguments on the Use of Contingencies on the Balance Sheet.--There exists conflicting opinions among accounting authorities as to the use of contingencies on the balance sheet. Some authorities hold that in order to give a "true and complete" report of a company's operations, contingencies should be presented only in footnotes thereto and not included within the balance sheet. Others hold that contingent liabilities should be presented within the balance sheet but that contingent assets should not because to do so would be to recognize income prior to its realization.

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[1]Eric Kohler, A Dictionary for Accountants (New Jersey: Prentice-Hall, Inc., 1963), p. 426.

[2]Hiram L. Jome, Corporation Finance (New York: Henry Holt & Co., 1948), p. 14.

Of those supporting the latter premise, there is the argument that it does not hurt a company to be prepared for uncertainties of a possible adverse nature but it does hurt to let others (shareholders) know of your defenses before you have proof of their existence yourself. In other words, why record your "assets" before you have proof of their existence but why not record possible liabilities. It has never hurt a company to be prepared for unfavorable events. And, if the uncertain debt does not materialize, the appropriation can always be returned to its originator--retained earnings.

Of course, the American Institute of Certified Public Accountants Committees on Accounting Procedure and Auditing Procedure are constantly researching and revising the Institute's opinions of the balance sheet approach afforded contingencies. Presently, the Institute is of the opinion that legal contingencies, which differ from general risk contingencies such as war, strike, etc. because of their indistinctive accounting nature, may be placed either on or off the balance sheet according to their nature. (Further discussion of this item is given in the section on Regulations of the AICPA and SEC.)

Unfortunately, out of all the research which has been done on this most timely topic, there has not emerged any specific criteria to be used in reporting contingencies. This state of affairs exist presently because any existing contingency may or may not develop into a determinable liability. The approach to be used is still left almost entirely to the discretion of the accountant.

CHAPTER TWO

ACCOUNTING FOR CORPORATE CONTINGENCIES

Regulations of the AICPA and SEC.--Although the Securities and Exchange Commission acts as the "governess" of all corporations in America to prevent fraud and deceit, the American Institute of Certified Public Accountants acts as their "legislator". These two bodies, however, cooperate with each other in establishing the guidelines both individually and collectively for the corporations.

> Regulation S-X is the "principal accounting regulation of the SEC in its administration of the Securities Act of 1933 and the Securities Exchange Act of 1934. . . . Regulation S-X relates generally to the form and content of financial statements and supporting schedules required in most of the registration statements and reports under both acts.[1]

These instructions in the Regulation on form and content represent the minimum requirements for the Commission also checks out the official standing of the auditor, examines the records carefully to detect fraud or deceit, and investigates various other avenues an outsider would consider unnecessary.

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[1]Norman Lenhart and Philip Defliese, Montgomery's Auditing (8th ed.; New York: The Ronald Press Company, 1957), p. 573.

Among the laws which the American Institute of Certified Public Accountants has established in relation to the selection of contingent items, the following rules apply:

> (1) A commitment which is not dependent upon some significant intervening factor or decision should not be described as a contingency . . .
>
> (2) Contingencies [where the outcome is reasonably foreseeable] which are expected to result in losses should be reflected in the accounts . . .
>
> (3) Contingencies which might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization.
>
> (4) Several items which may be classified as contingencies are not because they do not possess the degree of uncertainty usually associated with contingencies. Examples are: unusual letters of credit, long-term leases, assets pledged as security for loans, pension plans, cumulative preferred dividends in arrears.[1]

The Institute's Committee on Accounting Procedure feels that . . .

> the disclosure should be based as to its extent on the judgment in the light of the specific circumstances and should indicate the nature of the contingency, and should give an appraisal of the outlook. If a monetary estimate of the amount involved is not feasible, disclosure should be made in general terms describing the contingency and explaining that no estimated amount is determinable. When amounts are not otherwise determinable, it may be appropriate to indicate the opinion of management or counsel as to the amount which may be involved. In some cases, such as lawsuits involving a substantial amount, management may reasonably expect to settle the matter without

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[1]AICPA, <u>op. cit.</u>, p. 37-38.

> incurrence of any significant liability; however, consideration should be given to disclosing the existence of the litigation and the opinion of management or counsel with respect thereto.[1]

Not only are the Securities and Exchange Commission and the American Institute of Certified Public Accountants interested in how a company reports its financial situation but the Internal Revenue Service Tax Division is interested also. In addition to the corporations being required to furnish the Internal Revenue Service with a copy of their annual reports, they are compelled by law to pay a certain sum in money as taxes to its Tax Division. If a company pays too much or too little in taxes, herein lies its asset or liability contingency, as aforementioned.

The tax authorities require all companies to be consistent and conservative in their practices. Any change or deviation from the ordinary should be granted by them at least a year in advance or there may be reason to suspect fraud. In short, full disclosure is of primary concern to all three of these authoritative bodies.

Classifications of contingencies.--"Contingent assets may be classified after other asset classifications when reported on the balance sheet."[2] "Contingent

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[1] _Ibid._, p. 38.

[2] Wilbert Karrenbrock and Harry Simons, _Intermediate Accounting_ (Standard vol.; Cincinnati: South-Western Publishing Co., 1958), p. 13.

liabilities, being seldom of a short-term or current nature, are usually reported on the balance sheet after or with other long-term liabilities."[1]

Two approaches to classifying contingent liabilities are mentioned here. The two approaches are "those which are and those which are not created by offsetting against corresponding asset accounts,"[2] and "those in which the amount is and those in which the amount is not determinable."[3]

These two methods may be equated. For example, those contingent liabilities which are offsetted by corresponding asset accounts with those contingent items which are of a determinable amount and generally placed on the balance sheet, such as notes receivable discounted, accommodation endorsements and guaranties, and unused letters of credit. The maximum amount of these items, however contingent, may be calculated with a reasonable degree of accuracy. And, if a reserve for such items is set up, the only fallacy that is encountered is that "too much" may be appropriated. Of course, such a situation can always be remedied. The amount which represents an "over-appropriation" can always be returned to the retained earnings account.

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[1]Lenhart and Defliese, op. cit., p. 370-371.

[2]William Bell, Accountants' Reports (4th ed.; New York: The Ronald Press Co., 1949), p. 57.

[3]Lenhart and Defliese, op. cit.

Those contingent liabilities which are not offsetted by a corresponding asset account may be equated with those contingent liabilities of an indeterminable amount. Examples of these are "continuing guarantees of product and legal or other claims against which there can be no recoupment."[1]

Reserve for contingencies is a retained earnings appropriation and should thus be placed in the retained earnings section of the balance sheet. However, "many balance sheets still show Reserves for Contingencies as a separate section on the liability side and let the reader make his own decision as to their meanings".[2] This, of course, is not a good accounting technique. Therefore, notes or footnotes to the balance sheet should accompany the statement to explain such items.

Reporting of contingencies.--Asset contingencies are generally placed in the footnotes to the balance sheet. Karrenbrock and Simons has this to say concerning the reporting of contingent assets: "Contingent assets may be reported by means of a parenthetical remark or a special note under a separate contingent assets heading after other asset

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[1]Bell, op. cit.

[2]Edison Easton and Byron Newton, Accounting and the Analysis of Financial Data (New York: McGraw-Hill Book Company, Inc., 1958), p. 324.

classifications. . . . Reference to contingent assets is relatively infrequent in practice."[1]

If shown on a balance sheet, however, contingent assets are not included in the aggregate valuation of the assets. In other words, they are reported in short.

There are two stipulations affecting the reporting of contingent assets in the accounts. They are: "materiality and reasonable likelihood of realization."[2] . . . failure to disclose them may result in concealing important information."[3]

In addition to the previous methods of reporting contingent assets, they may be placed "in the assets with a contra provision deducted from the assets or included in the liabilities."[4]

There are several acceptable methods of reporting contingent liabilities on the balance sheet. These methods are "by means of account balances (notes receivable discounted shown deducted from notes receivable), by means of a separate section in which the money amounts of the reported contingent liabilities are not added to the amounts of equities reported on the balance

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[1]Karrenbrock and Simons, op. cit.

[2]Bell, op. cit.

[3]Lenhart and Defliese, op. cit., p. 305.

[4]Ibid.

sheets, or by means of footnotes".[1]

In addition to the above, Bell has this to say concerning the reporting of contingent liabilities on the balance sheet:

> . . . where there are offsetting contingent assets, the items are frequently shown on both sides and included in the totals. For example, the commonest item, customers' notes and acceptances discounted may be shown thus:
>
> Assets--Notes and acceptances receivable discounted (see contra) $100,000
> Liability--Discounted notes and acceptances receivable (see contra) 100,000[2]

Of course, the method a company uses in reporting contingent liabilities on the balance sheet depends upon the conditions in each case.

> If there is a strong probability that a liability and loss will develop . . . , a loss provision usually would be created by charge to income; accountants who are not advocates of the clean surplus theory might, under some circumstances, consider that a charge to Retained Earnings would be in order. The account thus created might be deducted from the related asset or shown as a liability--usually in the current section.
>
> If the probability of loss is remote but disclosure is nevertheless desirable, the disclosure may be made by the creation of a contingency reserve (appropriation of retained earnings) or by a footnote. The use of footnotes is increasing because the nature and purpose of appropriated surplus reserves are not widely understood and footnotes can be made much more informative.[3]

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[1]Miller, op. cit., p. 96.

[2]Bell, op. cit.

[3]H. A. Finney and H. E. Miller, Principles of Accounting: Intermediate (5th ed.; New Jersey: Prentice-Hall, Inc., 1963), p. 437.

Reserves or appropriations for contingencies are usually set up "if the contingency approaches a reality. . . . If the contingency appears fairly remote, a footnote to the balance sheet will provide the necessary disclosure."[1]

It is not unusual today to find that several companies utilize the reserve for contingency account. However, such reserves are often for "general risk contingencies" which are not contingencies in the legal sense because they are not the result of past events but are set up in anticipation of future events. Examples are self-insurance, war, strike, storm, etc. This does not mean that they may never be contingent in the legal sense.

The American Institute of Certified Public Accountants Committee on Terminology in its Bulletin No. 1 (1953), Review and Resume limits the use of the term reserve

> ... to indicate that an undivided or unidentified portion of the net assets, in a stated amount, is being held or retained for a special purpose as in the case of a reserve . . . (d) for general contingencies . . . to indicate an estimate of (a) an admitted liability of uncertain amount, as in the case of a reserve for damages, (b) the probable amount of a disputed claim, as in the case of a reserve for additional taxes, or (c) a liability or loss which is not certain to occur but is so likely to do so as to require recognition, as in the case of a reserve for self-insurance.[2]

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[1]C. A. Smith and J. G. Ashburne, Financial and Administrative Accounting (New York: McGraw-Hill Book Company, Inc., 1955), p. 162.

[2]Lenhart and Defliese, op. cit., p. 366.

The Committee is also of the opinion that general contingency reserves, such as those created:

(a) for general undetermined contingencies, or
(b) for a wide variety of indefinite possible future losses, or
(c) without any specific purpose reasonably related to the operations for the current period, or
(d) in amounts not determined on the basis of any reasonable estimates of costs or losses,

are of such a nature that charges or credits relating to such reserves should not enter into the determination of net income. Hence,

(1) Provisions for such reserves should not be included as charges in determining net income.
(2) When such a reserve is set up, it should be created preferably by a segregation or appropriation of surplus.
(3) Costs or losses should not be treated as charges to such reserves, and no part of such a reserve should be transferred to income or in any way used to affect the determination of net income for any year.
(4) When such a reserve or any part thereof is no longer considered necessary, it should be restored to surplus.[1]

Among the methods to be used in recording contingent assets, contingent liabilities, and their related reserves for contingencies on the balance sheet, the following examples are given:

a) Note: The Company has a contingent liability as guarantor of principal and interest on $600,000 first mortgage 5% bonds of B. & C. Company, $380,000 of which are held by the public.

b) Footnote: *Although a full reserve has been provided against the accounts receivable classified as doubtful, it appears that a considerable portion will be collected.

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[1] Finney and Miller, <u>op. cit.</u>, p. 441-442.

c) In the balance sheet:

Current assets:	
Notes receivable	$5,000
Less: notes receivable discounted	1,000
Notes receivable on hand	4,000

d) In the balance sheet as a liability in short:

Liabilities

Current liabilities:		
Notes payable	$44,500	
Accounts payable	35,250	
Accrued expenses	4,200	
....		$114,450
Contingent liabilities:		
Guarantors on employees' loans	7,500	
Customers' drafts discounted	12,000	
Additional income tax assessments proposed by the Treasury Department for 1956 that are being protested by the Company	4,500	
Total contingent liabilities	24,000[1]	

e) Reserve for contingencies in the balance sheet:

Retained earnings:	
Appropriated for contingencies	$30,000
Unappropriated	50,000
Total Retained earnings	80,000

Auditing procedures for contingencies.--At the close of a company's fiscal year it is a governmental requirement that the company's books be audited by an authorized person. Such a person is usually a certified public accountant.

[1] Karrenbrock and Simons, op. cit., p. 247.

As with the audit of other balance sheet items, the auditor must complete a detailed inquiry, analysis, and summarization of the company's contingent items and/or any other items which he feels are possible contingencies.

It is his responsibility to "establish the amounts of contingent assets or the existence of contingent assets of undetermined amount by inquiry and by examination of supporting written evidence."[1]

Among the supporting written evidence he may depend on in his examination are "minutes of meetings of the board of directors, partners, and special committees; correspondence with client's attorney, purchase contracts, sales contracts, lease agreements, correspondence and invoices for professional services."[2] (A sample copy of the audit program for contingent liabilities may be found on the following page.)

Often the existence of contingent items may be "deliberately hidden from the auditor"[3]; therefore, he should make every effort to satisfy any doubts he may possess concerning the status of any item.

His inspection of the minutes books may "reveal the presence of contracts, possible or pending litigation, and other matters indicating contingent

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[1] Lenhart and Defliese, op. cit., p. 303.

[2] Arthur W. Holmes, Basic Auditing Principles (Illinois: Richard D. Irwin, In., 1962), p. 261.

[3] Lenhart and Defliese, op. cit., p. 375.

ILLUSTRATION I

AN AUDIT PROGRAM

Client ______________________________

Audit for Fiscal Year Ending ______________ 19 __

Contingent Liabilities and Purchase Commitments

	Performed By	Date	WP No.
1. Examine the minutes of meetings of board of directors.	____	____	____
2. Examine contracts for purchases, sales, leases; and invoices, correspondence, guarantees, etc.	____	____	____
3. Obtain opinion of client's attorney as to possible liabilities materializing from pending litigation.	____	____	____
4. Notes receivable discounted.	____	____	____
5. Discuss with officers and key employees.	____	____	____
6. Ascertain amount of outstanding commitments for purchase of materials or services.			
(a) Any possible loss involved?	____	____	____
(b) Are amounts normal? Abnormal?	____	____	____
7. Prepare notes for balance sheet.	____	____	____

Received by ______________ Date __________[1]

liabilities to be investigated and possibly recognized in the financial statements".[2] "The auditor should review with management the possibility of contingent liabilities . . . not determinable from the accounts.

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[1]Arnold W. Johnson, Auditing: Principles and Case Problems (New York: Rinehart & Company, Inc., 1959), p. 648-649.

[2]Lenhart and Defliese, op. cit.

A statement of management as to contingent liabilities is included in the liability certificate . . ."[1]

Contingent liabilities may be revealed "by the banks' replies to confirmation requests . . .; these include a request for a statement of the client's liabilities as acceptor, endorser, or guarantor of notes, drafts, and acceptances".[2]

In addition to the auditor's obtaining written information from the company's banker and lawyer, "the client's records should be scanned for the names of attorneys who have been paid, and usually information should be requested from all of them".[3]

The accounts receivable should be checked to determine whether any have been "discounted without being recorded. The checking of accounts receivable require the examination of dealings with discount companies evidenced by the receipt of cash or payment of interest. These items may or may not prove to be contingent."[4]

Of course, any commitments of subsidiaries or affiliates which have been guaranteed by the parent company should be examined. "These may not appear in the parent company's records but may represent a con-

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[1] Ibid.

[2] Lenhart and Defliese, op. cit.

[3] Ibid.

[4] Ibid., p. 376.

ILLUSTRATION II

LIABILITY CERTIFICATE

LEE AND COMPANY Date ___________
CERTIFIED PUBLIC ACCOUNTANTS

In connection with the audit of our records for the year ended December 31, 1962, we certify that to the best of our knowledge:

1. All direct liabilities have been recorded in the accounts, including all items in transit for which we had been billed and to which we had title.
2. As of December 31, 1962, contingencies are as noted below:
   a) Discounted notes, drafts, and acceptances .... $ _________
   b) Accounts or notes assigned .... _________
   c) Accommodation endorsements of the paper of others .... _________
   d) Lawsuits and judgments .... _________
   e) Financial commitments not in the regular course of ordinary business _________
   f) Open balances on letters of credit.. _________
   g) Additional taxes for prior years.... _________
   h) Purchase commitments for materials at prices in excess of current market quotations or for quantities in excess of normal requirements _________
   i) Guarantees of debts of affiliated companies.......................... _________
3. There is no subordination of liabilities. _________
4. Company assets were pledged or hypothecated as liability security, other than as noted in 2, above, in the amount of $_________
5. The contracts for construction and/or purchase of fixed assets amount to.... $_________

Signed ___________________________ Title ___________

Signed ___________________________ Title ___________[1]

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[1]Holmes, _op. cit._, p. 263.

tingent liability that should be recognized."[1]

The American Institute of Certified Public Accountants Statement on Auditing Procedure No. 25 requires an auditor to include the present state of contingent items in its report up to the report date. It thus states that . . .

> liabilities properly considered contingent on the balance sheet date, if determined to be actual during the auditor's examination, should be treated as though such later determination had been known at the balance sheet date, and the financial statements should be appropriately adjusted.[2]

Subsequently, the auditor's task is made more difficult because of this added responsibility. Therefore, not only must he examine the contingent items and explore the possibility of future ones, he must also keep abreast of their corporate status throughout the audit.

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[1] Ibid.

[2] Ibid., p. 377.

CHAPTER THREE

ANALYSIS OF A RANDOM SAMPLE

Background of the sample.--As the thesis progressed, the need arose for more authentic evidence of the present status of corporate contingencies on the financial statement. As a result of this necessity, a random sample was taken through the use of a questionnaire. This questionnaire, designed to revive the past as well as the present significance of corporate contingencies, proved to be quite informative.

The fifty companies used represented some thirteen industries[1] obtained from among the 500 largest industrial corporations in the United States. Even though only thirty-two (64%) of the fifty corporations written to responded and complete cooperation was not obtained from all of them, these proved to be sufficient for an effective sample analysis.

As previously mentioned in Chapter Two, corporate contingencies are becoming quite popular

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[1]The manufacturing industries represented are: car, steel, tobacco, petroleum, electric and electronics, tire and rubber, office equipment, aircraft, telephone and telegraph, container, drugs and chemicals, food and sugar.

as footnotes or notes to the balance sheet and quite unpopular as balance sheet items. This statement is substantiated by the following excerpt in reference to liability contingencies--remaining cognizant of the fact that most contingencies generally are of a negative nature: "Contingent liabilities, although occasionally shown as memorandum in the body of the balance sheet, generally appear as footnotes . . ."[1]

Evidence of the past significance of corporate contingencies show that one of the periods in which the greatest emphasis was placed on contingencies in general was the span between the depression years and the end of World War Two. However, at the time the term "contingencies" had not been as clearly defined as it is today. In other words, the term contingencies then referred to both legal contingencies and general risk contingencies with both possessing the same connotation. The Institute's Committee on Accounting Procedure is constantly striving to make the lines of distinction even clearer.

In reading the interpretation of the results

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[1] Johnson, *op. cit.*, p. 236.

of the questionnaire the reader should remain aware of the fact that each industry and company as well differ significantly in their respective interpretation and/or definition of contingencies.

The names of the participating corporations are deemed confidential. Therefore, direct reference to any particular company is avoided as much as possible.

Interpretation of the sample results.--
In an attempt to further clarify their concept of contingencies several companies have for some time merged their former contingency account(s) into retained earnings. For example, one company states that it formerly had two contingency accounts. However, its independent certified public accountant ruled that both were arbitrary and were actually stockholders' funds and belonged in the net worth section of the balance sheet. The American Institute of Certified Public Accountants upheld this view and so both accounts were collapsed into earned surplus. The same company also feels that contingency accounts are looked upon with disfavor under today's accounting techniques.

Of the corporations which did respond, 43.75 per cent still make some type of provision for contingencies, 37.50 per cent do not make any type of provision for contingencies, and 18.75 per cent did not respond to the question.

Among the 43.75 per cent which do make some provision for contingencies, 35.71 per cent give recognition of the item within their footnotes, whereas only 21.43 per cent recognize the item in their liability section (See Table I). This only further supports the statement previously made that contingencies are becoming more and more popular as footnotes and/or notes to the balance sheet.

Very little recognition is given to contingent assets (7.14%). It is questionable whether this was intended to imply that most companies do not realize or recognize asset contingents or that they simply do not encounter any assets of this nature to be realized or recognized on the books.

Examples of the notes and footnotes relative thereto are:

1. Contingencies: At December 31, 1965, the Corporation had contingent liabilities of $24 million on account of customers' notes sold to banks, guaranteed loans, etc.

2. The Corporation was contingently liable as guarantor on loans outstanding of certain associated companies in the amount of $29 million. Also, under long-term agreements with certain pipe line companies in which stock interests are held, the company guarantees specified revenue from product shipments and, in the event such companies are unable to meet debt obligations, the company may be required to advance funds against future transportation charges. No loss is anticipated by reason of such obligations.

TABLE I

CLASSIFICATION OF 14 AMERICAN CORPORATIONS WHICH GIVE BALANCE SHEET RECOGNITION TO CONTINGENCIES ACCORDING TO PATTERNS OF REFLECTION, 1965

Patterns of Reflection	Number	Per Cent of Total
Total	14	100.00
As footnote	5	35.71
As deduction from asset	1	7.14
As liability	3	21.43
As item of owners' equity	2	14.29
Would not say--"confidential"	2	14.29
Some as a deduction from asset and some as liability	1	7.14

3. Contingent liabilities: There are various claims against the Corporation and its consolidated subsidiaries in respect to sundry taxes, suits, patent infringements and other matters incident to the ordinary course of business, together with other contingencies. While there is no way of determining the eventual liability for these claims and contingencies, the amounts included in liabilities and reserves in the financial statements of the Corporation and its consolidated subsidiaries are, in the opinion of the management (and General Counsel with respect to certain suits), adequate to cover all settlements that may be made.

Very few responses were received on the question of whether the company find it necessary to make an allocation to the reserve account annually. Of those who responded, only 12 per cent made an allocation annually.

The provisions made for contingencies may be found under varying titles on and off the balance sheet: Other Accrued Liabilities, Contingent Liabilities, Allowance for Contingencies, Commitments and Contingencies, and Reserve for Insurance, Contingencies and Accident and Hospital Expenses. Of course, as one would probably suspect, most of the emphasis is placed on liability contingencies.

The analysis of the fourteen American corporations which do maintain contingency accounts show that the iron and steel and the petroleum industries take precedence in giving recognition to contingency accounts (See Table II). No apparent reason was given. However, it can be inferred from their Notes to the Financial Statements that these corporations make more allowances for contingencies because of their associations with their subsidiaries as guarantors of notes, loans, and performance under contracts. There is, of course, the possibility of some other reason but because of the ambiguity of the information given in their notes, it is difficult to decipher any other reason.

It is only appropriate that attention should be given to those industries which do not give recognition to contingencies. Some of their reasons for not making

TABLE II

CLASSIFICATION OF 14 AMERICAN CORPORATIONS WHICH MAINTAINED CONTINGENCY ACCOUNTS ACCORDING TO INDUSTRY, 1965

Industry	Number	Per Cent of Total
Total	14	100.00
Iron and steel	3	21.43
Petroleum	3	21.43
Electric and electronics	1	7.14
Office equipment	1	7.14
Aircraft	2	14.29
Communications	1	7.14
Chemicals and drugs	2	14.29
Rubber	1	7.14

any provision for contingencies may help to explain why the other companies did make provisions for contingencies.

Some of the reasons given for not making any provision(s) or discontinuance of methods formerly employed were:

(1) present accounting concepts frown upon such reserves,

(2) end of the war erased the need for the account

since the company was no longer engaged in defense business,

(3) present company policy does not allow for such reserves.

A look at Table III shows little evidence of variance among the number of companies which do not maintain contingency accounts on their books. Of course, this is not surprising because there is a growing trend among the corporations to find a need for the account(s) in view of the present continuous change in the accounting techniques.

Not only were there reasons given for not having a contingency account(s) but reasons were also given for having the account. Among the reasons given for having such an account, "conservatism", tends to be the most prevalent.

Each company tended to have its own reason for setting up a contingency account(s) and its related reserve. Among the reasons given, the following apply:

(1) to absorb any extraordinary losses which might arise from foreign operations including those associated with major currency revaluation,

(2) conservatism,

(3) for specific unanticipated losses other than those which are covered by the insurance reserve.

The criteria given which a company utilizes in determining the items to be included in the contingency account and/or its related reserve account

TABLE III

CLASSIFICATION OF 12 AMERICAN CORPORATIONS WHICH DID NOT MAINTAIN CONTINGENCY ACCOUNTS ACCORDING TO INDUSTRY, 1965

Industry	Number	Per Cent of Total
Total	12	100.00
Chemicals and drugs	1	8.34
Food	2	16.67
Sugar	2	16.67
Automobile	1	8.33
Tobacco	2	16.67
Electric and electronics	1	8.33
Office equipment	1	8.33
Aircraft	1	8.33
Container	1	8.33

are:

(1) the judgment in each individual case,

(2) evaluation of risks and potential losses,

(3) company liability as estimated by counsel --if it can be estimated.

Very little response (11%) was received on the question of whether or not competition had any effect on the company's decision to set up an account for contingencies initially.

Allowing for the fact that company policies have a great deal of influence on the disclosure of information relating to the topic, it was not surprising to find that most of the corporations were vague and/or evasive in their responses.

CHAPTER FOUR

SUMMARY AND CONCLUSION

Recognizing that there exists differences in the opinions of the various corporations and industries regarding the nature and accounting of corporate contingencies, it was not surprising to find situations of conflicting ideas. Even though there is no primary evidence to support it, perhaps contingencies are one of the items which induces much of the differences in opinion regarding corporate taxation.

Since the reserve for contingencies is usually a retained earning item, it is believed by some authorities that such a segregation is only a disguise which management uses to prevent paying dividends to shareholders. The Securities and Exchange Commission, of course, is always on the alert for this and other forms of "misappropriations".

Among the "guidelines" corporations use in accounting for contingencies, the following generally take precedence:

(1) possession of a reasonable degree of uncertainty,

(2) is the result of some past event the exact amount of which is unknown,

(3) has not as yet developed into a legal obligation,

(4) is a part of the ordinary incurrences of that particular business. In other words, not a general risk item which may be "incurred" by any business as hurricanes, fires, depressions, strikes, etc.

It is hoped that this paper has achieved its purpose as a reference material for anyone interested in the topic and especially for the beginning accounting student. Items which may appear to be contradictory are the result of the conceptual differences between the individual authors and/or corporations.

It is hoped that within the next few years clearer definitions will have been made in the accounting for contingencies or the item made obsolete in accounting usage. Of course, our gratitude goes primarily to the American Institute of Certified Public Accountants for the present information on corporate contingencies and, I believe, if there is to be any future achievements in this area, the information will be disclosed by the same body.

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